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A Uniform Physical Presence Standard Would Limit Destructive State Efforts to Export Tax Burdens

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Mr. Chairman, Ranking Member Franks, and members of the Committee:

With online retail transactions accounting for a significant and growing share of total sales, the importance of preserving the free flow of interstate commerce grows as well.

It is not new for states to seek revenues by shifting tax burdens away from the majority of voting residents, such as with changing nexus rules. Because economic integration is greater now than it has ever been before, the economic costs of nexus uncertainty are also greater today and can ripple through the economy much more quickly.

For example, if a New York company sells a product on its website to a California purchaser via servers in Ohio and Colorado, is the transaction everywhere, nowhere, or always somewhere at a given point in time?

A physical presence rule provides a logical answer to where the transaction is located, identical to the answer given for brick-and-mortar businesses: in this case, New York, where the company's property and payroll are located. Proponents of economic nexus are mostly unanimous in rejecting that choice, but they would substitute only uncertainty about the ultimate answer.

Inflicting this uncertainty on our economy, as states have begun doing in absence of a uniform physical presence standard, has been disastrous.[1] As long as state tax systems are defined by geographical lines, consistency requires that taxes be imposed only on individuals and businesses within those geographical lines. States are limited in their powers and this includes geographic limits to the power of taxation.

Key Findings

- It is not new for states to seek revenues by shifting tax burdens away from the majority of voting residents, such as with changing nexus rules.
- A physical presence rule provides an easy and logical answer to where the transaction is located, identical to the answer given for brick-and-mortar businesses.
- Efforts to move away from the physical presence standard in taxation threaten to do long-term harm to economic growth and undermine the principles of sound tax policy: simplicity, neutrality, transparency, and stability.
- Congressional action to adopt a physical presence standard may be the best vehicle for preventing burdens to interstate commerce, because it can be more comprehensive and accountable than judicial action and can also better address issues of transition, retroactivity, and *de minimis* exemptions.

Our written testimony makes two broad points. First, the physical presence standard limits destructive and likely unconstitutional state efforts to export tax burdens, efforts that stifle interstate commerce and harm economic growth. Second, a uniform physical presence standard would decrease transaction costs for interstate commerce, especially small businesses using mail and the Internet.

A Uniform Physical Presence Standard Limits Destructive and Likely Unconstitutional State Efforts to Export Tax Burdens

The U.S. Constitution came about in large part because the federal government initially had no power to stop states from setting up trade barriers between each other. Many states sought, as they do today, to protect domestic enterprises by burdening or discouraging out-of-state competitors with heavy taxes and import restrictions, harming these businesses and the economy as a whole. This race to the bottom directly led to granting Congress the power to regulate interstate commerce.[2]

State officials still have every incentive to pursue *beggar-thy-neighbor* tax policies designed to shift tax burdens from voting in-state residents to out-of-state residents and businesses unable to resort to the ballot box. Not only does democracy not prevent harmful tax exporting from occurring, it actually worsens it, since services can be provided to a majority of voters, paid for by non-voters.

As scholar Daniel Shaviro put it, "Perceived tax exportation is a valuable political tool for state legislators, permitting them to claim that they provide government services for free."[3] The Supreme Court, using its dormant commerce clause jurisprudence, has intervened to stop some of the more egregious state actions; but its scope and power in this regard is limited.[4] It is thus up to Congress to exercise its power to protect interstate commerce.

The Tax Foundation has catalogued the growth in state tax exporting. Increasingly, states have imposed higher, non-neutral taxes on individuals, goods, and services more likely to be used by non-residents. Our research has reviewed such taxes on visiting athletes, businesses engaged in interstate commerce, and hotel rooms and rental cars. States have also enacted subsidies and tax credits only available to favored in-state activities, and have shifted corporate tax burdens by changing apportionment and nexus rules.

As these states have reached beyond their borders for a larger share of taxes that would otherwise go to other states, they have reduced neutrality in the tax system, burdened interstate transactions with uncertainty, increased compliance costs, and threatened multiple taxation of the same business income by different states.

A recent nexus case involved West Virginia's levy of a quarter million dollars in state taxes on a company (MBNA, now FIA Card Services) whose only connection to West Virginia is that some of its customers now live there.[5] Although MBNA had property and 28,000 employees around the world, none of them were in West Virginia. And although a quarter million dollars may not be considered much for a company with profits of over $1 billion per year, MBNA had tax liability on those profits in the state where its employees and property were: Delaware. If every state were to impose similar taxes on every company, the negative impact on the economy would be serious.

A business with property and employees in a state is properly subject to state taxation, as the Supreme Court emphasized in its famous *Complete Auto Transit* case in 1977.[6] Known to economists as the "benefit principle," liability to state taxation is usually described as a form of proxy payment for enjoying police protection, access to courts, and state-maintained roads. This idea, that a company pays taxes in return for benefits derived from being physically present in a state, is reflected in the test adopted in *Complete Auto*, which requires that "the tax must be fairly related to services provided to the taxpayer by the state," as well as requiring that there must be "a sufficient connection between the taxpayer and the state."[7]

Opponents of physical presence nexus argue that out-of-state businesses must be subject to income and sales tax since their sales into the state enjoy the benefit of a functioning economy. If a business does not have property or payroll in a state, true application of the benefit principle makes these arguments less compelling. Sales over the Internet or through the mail that happen to pass through a state, or terminate in a state, do not use state services.

Such services are used primarily, if not exclusively, by in-state residents and it should be their responsibility to finance. To allow interstate transactions to be nickel-and-dimed by state taxing authorities as they make their way across the continent would impose, and has imposed, a huge burden on interstate commerce.

In *Quill v. North Dakota* (1992), the U.S. Supreme Court reaffirmed the rule that a state cannot impose sales tax collection obligations on a business unless that business is physically present in the state.[8] The Court broadly recognized that states seek to impose greater tax burdens on businesses that are not physically present, which by definition are taxes on activity occurring out-of-state. The only way to ensure that states are not burdening activity out of state more than activity in state is to limit state tax collections of all kinds solely to businesses with a physical presence.

A Uniform Physical Presence Standard Would Decrease Transaction Costs for Interstate Business Activity

Businesses throughout our nation's history have plied their trade across state lines. Today, with new technologies, even the smallest businesses can sell their products and services in all fifty states through the Internet and through the mail. If such sales can now expose these businesses to tax compliance and liability risks in states where they merely have customers, they will be less likely to expand their reach into those states.

Unless a single nexus standard is established, the conflicting standards will impede the desire and the ability of businesses to expand, which harms the nation's economic growth potential.

We here at the Tax Foundation track the numerous rates, bases, exemptions, credits, adjustments, phaseouts, exclusions, and deductions that litter our federal and state tax codes. Frequent and ambiguous alterations of tax codes and the confusion they cause are a key source of the growing tax compliance burden. We have several staffers as well as computer-based and publication subscriptions dedicated to being up to date and accurate on the frequent changes to the many taxes in our country, but even we have trouble doing it. It would be extremely difficult for retailers who are in business to sell a good or service, not to conduct tax policy research.

Under either physical presence or economic nexus, brick-and-mortar stores need to worry only about the tax system where they are physically present. The same would be the case for online retailers under a physical presence standard. But under an economic nexus standard, out-of-state and online businesses would have to pay income and sales taxes based on where their *customers* are located. This would burden e-commerce more than brick-and-mortar business, and effectively impose an exit toll on outbound commerce.

There is a high likelihood that e-commerce would become subject to multiple taxation under an economic nexus standard. That would not occur under a physical presence standard because only one state may claim a certain share of business income at a time. It's easy to do—one just looks to see where employees and property are.

An economic nexus rule, by contrast, complicates matters. In the *MBNA* case, West Virginia sought to tax income that is already subject to Delaware taxation. Even though *Complete Auto* says that a state cannot tax beyond its fair share, multiple states would assert that they are entitled to tax the income. States are unlikely to smooth out such agreements for the same reason that rules for divvying up state corporate income have become less uniform. Without a uniform standard, multiple taxation and substantial litigation surrounding it could arise.

States' adoption of economic nexus also raises questions of temporal limitations. How far in space and time does economic nexus go? States vary widely on how long nexus lasts after in-state activity occurs: three states say twelve months, the State of Washington says five years, two states say it ends on the day the physical presence ends, and in Indiana, nexus apparently lasts forever.[9] Only a uniform federal standard can provide a rational and comprehensive answer to the question of how far is too far and how long is too long.

These problems—tracking state tax rates and bases in 8,000+ jurisdictions, litigation, inequity, multiple taxation, and unpredictability—are associated with economic nexus. A uniform physical presence standard for all forms of taxation would avoid many of these problems.

Conclusion

The Internet has seen an increased amount of commerce, but some seem to view it as a golden goose that can be squeezed without adverse effects on economic growth. It must be understood that the availability of many items in electronic commerce could be hindered if states are permitted to adopt economic nexus standards.

States will reach for as much revenue as they can, if they believe that it can benefit them even at the expense of other states and the nation as a whole. A uniform physical presence standard would restrain these efforts, maintain a level playing field for all types of businesses, and reduce costs and burdens to interstate commerce.

Congress can obtain evidence from interested stakeholders and take political and economic factors into consideration when developing new rules of taxation. The Supreme Court, by contrast, must develop broad doctrine in a case-by-case fashion, based on the facts of the particular case before them. (Additionally, the Court seems to have an aversion to tax cases.)

This is why congressional action, which can be more comprehensive and accountable than judicial action, and can better address issues of transition, retroactivity, and *de minimis* exemptions, may now be the best vehicle for preventing burdens to interstate commerce by adopting a uniform physical presence standard. It is up to Congress to exercise its power to protect interstate commerce.

We now live in a world of iPods, telecommuting, and Amazon.com. It is a testament to the Framers that their warnings about states' incentives to hinder the national economy remain true today.

Some may argue that faster roads and powerful computers mean that states should now be able to tax everything everywhere. While some constitutional principles surely must be revisited to be applied to new circumstances, the idea that parochial state interests should not be permitted to burden interstate commerce remains a timeless principle regardless of how sophisticated technology may become.

Notes

1. Replacing a physical presence standard with a "modern" one has caused uncertainty and economic dislocation before. *See* Joseph Henchman, "Why the Quill Physical Presence Rule Shouldn't Go the Way of Personal Jurisdiction," *State Tax Notes* (Nov. 5, 2007), available at http://tinyurl.com/5jsykb.

2. *See, e.g., Gibbons v. Ogden,* 22 U.S. 1, 224 (opinion of Johnson, J.) ("[States,] guided by inexperience and jealousy, began to show itself in iniquitous laws and impolitic measures . . ., destructive to the harmony of the States, and fatal to their commercial interests abroad. This was the immediate cause that led to the forming of a convention.").

3. Daniel Shaviro, "An Economic and Political Look at Federalism in Taxation," 90 Mich. L. Rev. 895, 957 (1992).

4. For a discussion of past cases, see Joseph Henchman, *Defending Competitive Neutrality Before the Supreme Court*, Tax Foundation Special Rep. No. 158 (Nov. 2007).

5. *See Tax Comm'r of State v. MBNA America Bank, N.A.,* 640 S.E.2d 226 (W.V. 2006), cert. denied, 75 U.S.L.W. 3676 (U.S. Jun. 18, 2007) (No. 06-1228).

6. *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977).

7. *Id.* at 279.

8. *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992).

9. *See* H. Beau Beaz III, *The Rush to the Goblin Market: The Blurring of Quill's Two Nexus Tests,* 29 Seattle U. L. Rev. 581, 622 (2006).
